The following is the Franchise Tax Board's analysis of AB 530 (Higher Education Committee) as amended September 4, 1997.

SUBJECT

Exclusion/Golden State Scholarshare Trust Income

SUMMARY

Under the Education Code, this bill would establish a prepaid tuition plan known as the Golden State Scholarshare Trust (Scholarshare), which would be administered by the Student Aid Commission (commission).

Under the Revenue and Taxation Code, this bill would provide an exclusion from gross income for any interest accruing on a Scholarshare account during the taxable year.

This analysis addresses the provisions of the bill that pertain to the income tax matters.

EFFECTIVE DATE

This bill would apply to taxable years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 13, SB 101 (1997); AB 2629, AB 3219, SB 1380 (1996).

BACKGROUND

Several states have adopted tuition prepayment programs that allow purchasers to pay in advance for educational costs of a designated beneficiary at a participating institution, usually an in-state public college. The programs pool all payments into one large fund and invest it with the goal of achieving a rate of return higher than the anticipated rate of tuition increases at participating colleges. When the beneficiary enrolls at a participating college, the program pays to the school the amount it charges at that time for tuition and fees and any other prepaid expenses, such as housing costs. In some states, purchasers sign contracts to pay for a certain type and amount of benefits, such as two years at a community college, two years at a community college plus two years at a state university, or four years at a state university. Other states allow purchasers to buy smaller units of benefits, such as college credit hours. The programs charge roughly current prices for tuition and fees and other prepaid benefits——in some cases, a premium may be charged; in others, a discount may be offered. Purchasers typically can choose between either one lump-sum payment or a long-term payment plan. Various refund provisions apply if the beneficiary cannot use the benefits due to death or disability, chooses not to go to college, or decides to attend a nonparticipating college. Under certain circumstances, a specified rate of interest may be paid on the refunded amount.

SPECIFIC FINDINGS

Existing federal law (P.L. 104-188, Stats. 1996, and amended by P.L. 105-34, Stats. 1997) provides that a state tuition program is qualified and exempt from federal taxation if it meets the following criteria:

1. Established and maintained by a state agency or instrumentality;
2. Purchases or contributions may be made only in cash;
3. More than a de minimis penalty is imposed on any refund of earnings from the account that are not:
   - used for qualified higher education expenses of the designated beneficiary;
   - made on account of the death or disability of the designated beneficiary; or
   - made on account of a scholarship received by the designated beneficiary to the extent the refund does not exceed the amount of the scholarship used for qualified higher education expenses;
4. Provides separate accounting for each designated beneficiary;
5. Provides that contributors and beneficiaries may not, directly or indirectly, direct the investment of any contribution to the program or earnings thereon;
6. Does not allow interest in the program to be used as security for a loan;
7. Prohibits contributions in excess of that necessary to provide for the qualified higher education expenses of the beneficiary, which are defined as tuition, fees, books, supplies, and equipment and reasonable costs for room and board; and
8. Provides for program reporting to the Internal Revenue Service (IRS) of distributions and educational benefits received.

This **federal law** provides that the gross income of the contributor or designated beneficiary does not include contributions to or earnings (at the time they are earned) under the program. However, distributions from the program in excess of amounts contributed (such as interest earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made. The furnishing of education to a designated beneficiary is considered a distribution.

Recently enacted federal law provides two other types of education-related tax incentives. The Hope credit program allows qualified taxpayers a nonrefundable credit of 100% for the first $1,000 of qualified tuition and related expenses and a 50% credit for the next $1,000 of qualifying expenses, for a total credit of $1,500 each year per student. Beginning in 2001, the credit is indexed for inflation. The tax credit is phased out for single taxpayers with a modified adjusted gross income of between $40,000 and $50,000 and for joint filers with adjusted gross income of between $80,000 and $100,000

The Lifetime Learning credit program allows taxpayers a nonrefundable 20% credit for up to $5,000 per taxpayer in qualified tuition and related expenses for graduate and undergraduate courses at an eligible education institution. The phase-out provisions for this credit are the same as those for the Hope credit.

Recently enacted federal law also provides that taxpayers may contribute up to $500 per beneficiary (until the beneficiary reaches the age of 18) to an education individual retirement account (IRA), a tax-favored trust, or custodial account created to pay the costs of a beneficiary's higher education. Contributions are not deductible, but withdrawals to pay the cost of a beneficiary's postsecondary school tuition and room and board are exempt from tax. The tax credit is phased out for single taxpayers with a modified adjusted gross income of between $95,000 and $110,000 and for joint filers with adjusted gross income of between $150,000 and $160,000.

For regular IRAs, **existing federal law** provides that the 10% early withdrawal tax does not apply to distributions used to pay the qualified higher education expenses (including those related to graduate–level courses). This program does not provide a phase-out limitation.

In each year, taxpayers may elect with respect to an eligible student to take either the Hope credit, the Lifetime Learning credit, or tax-exempt distributions from an education IRA. This election limitation does not apply to qualified distributions from a prepaid tuition program.

Existing federal and state laws provide that gross income includes all income from whatever source derived, including compensation, business income, gains from property, dividends, rents, interest, and royalties. In the case of interest, all interest received or credited to a taxpayer's account (accrued) is included in gross income unless it is specifically exempt.

Existing federal and state laws allow a deduction for penalties forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, or homestead association because of early withdrawal of funds from a time savings account, certificate of deposit, or similar classes of deposit.

Currently, **state law** does not contain provisions for a college tuition prepayment program.

Under the Education Code, **this bill** would establish the Golden State Scholarshare Trust. Under this bill, the California Student Aid Commission may enter into participation agreements with participants for the advance payment of qualified higher education expenses for a beneficiary to attend an institution of higher education. The participation agreement would provide the terms and conditions for payments made to the trust and the minimum rate of interest borne by the investment in the trust. The bill would provide an overall maximum investment level for a designated beneficiary of the amount equivalent to the maximum estimated qualified higher education expenses, as defined, that can be incurred by a beneficiary to obtain a baccalaureate degree at an institution of higher education in California for four years. The bill would provide a more than de minimus penalty if a participation agreement is canceled for reasons other than death or disability of the beneficiary or in the event the beneficiary receives a scholarship.

Pursuant to the participation agreement, the commission would invest the pooled trust moneys and any earnings therefrom inuring to the state would be used to make payments to institutions of higher education on behalf of beneficiaries and to pay for administration costs.

This bill would require the trust to provide an annual listing to the department of all Scholarshare distributions.

Under the Revenue and Taxation Code, **this bill** would provide an exclusion from gross income that would approximate the federal law by: (1) exempting from taxation to the participant or beneficiary earnings from the trust at the time they are earned; (2) providing that distributions from the program in excess of amounts contributed (such as interest earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made; and (3) providing that the furnishing of education to a designated beneficiary is considered a distribution.

This bill would require the Student Aid Commission to adopt regulations to implement the bill that are consistent with the requirements for exclusion or deferral from federal taxation.

This bill would specify that taxpayers who withdraw their funds early from a Scholarshare account (cancel their participation agreement) under this bill and incur a penalty would not be allowed the deduction for early withdrawal of savings.

Policy Considerations

The Scholarshare program that would be established by this bill would conform to the federal tuition program tax exemption, thereby eliminating a federal/state difference for the tax impact of this program and encouraging taxpayers to save for their children's higher education.

Implementation Considerations

Implementing this bill would occur during the department's normal annual system update.

Fiscal Impact

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in annual revenue losses largely under the PITL estimated to be as shown in the table below:

Estimated Revenue Impact of AB 530 As Amended 9/4/97 [$ In Millions]			
1997-98	1998-99	1999-00	2000-01
minor loss	($1)	($3)	($5)

Minor loss represents a loss of less than $500,000. The bill would be effective with taxable/income years after December 31, 1997.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the amount of investment income earned on funds contributed by participants and (2) the marginal tax rates of participants for the deferral of reported investment earnings.

The estimate was developed in the following steps:

1. Assumed that contributions by participants would otherwise have been placed in taxable investment vehicles yielding 8%;

2. Projected a number of participants who would enter the program each year;

3. Estimated the amount of contributions by participants; and

4. Applied an assumed average marginal tax rate of 6% for contributors.

Projected Number of Participant Agreements

The number of new annual participation agreements was projected by using a combination of tax return data and population projections by age for California, and by assuming an average annual participation rate of 1% and the effect of newly enacted federal education tax incentives. Roughly 4.9 million dependents are claimed on taxable California returns with adjusted gross incomes of $20,000 or more. Based on population projections by age for California, approximately 90% of claimed dependents are age 17 or younger. Based on participation rates for states with prepaid tuition programs, an average annual participation rate of 1% was assumed for California. Newly enacted federal law has provided new education tax incentives. It was assumed that these federal incentives, in general, will increase taxpayers' awareness of the education-savings programs. Thus, greater participation in the state program proposed in this bill is expected. Multiplying 4.9 million dependents by 90% and by 1% and factoring in the impact of federal tax incentives derives roughly 45,000 new participant agreements each year.

Income distributions of program participants in other states with prepaid tuition programs suggest that very few participants have annual family incomes of less than $20,000. Ages 17 or younger seem the most likely group for whom contracts would be purchased.

Level of Funding by Participants

For states with prepaid tuition credit programs, roughly 60% of participants purchase one year or less of tuition credits; about 30% purchase one to two years; and about 10% purchase two to four years.

Data collected by the Department of Finance indicate that, of the 1995 full-time enrollments in colleges and universities, approximately 39% attended public community colleges, 24% attended state universities, 17% attended a University of California, and 20% attended independent colleges or universities.

Combining this information allows development of a proxy for estimating a level of contributions by participants. It is assumed that participants would enter into agreements that would require sufficient amounts to pay higher education costs at either a state university, a University of California, or an independent college or university in amounts approximating the levels reported by states with prepaid tuition credit programs. (As calculated, 39% of participants would purchase tuition credits at a state university, 28% at a University of California, and 33% at an independent college or university [.24+.17+.20=.61; .24/.61=.39; .17/.61=.28; .20/.61=.33].

Based on information provided by the commission, maximum annual qualified higher education expenses were approximated for 1998 as follows:

Higher Education Institution	1998 Maximum Investment Level
State University	$ 8,450
UC	$10,650
Independent	$22,150

The estimate reflects both lump-sum and installment agreements and, for calculating otherwise taxable earnings on the amount of funding, reflects a mid-year payment date.

POSITION

Support.

NOTE: The Franchise Tax Board voted at its February 11, 1997, meeting to support Assembly Bill 13, which contains the same Scholarshare program as this bill.